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IN THE

Supreme Court of the United States

OCTOBER TERM, 1939.

No. [redacted] 5

HARRY H. NEUBERGER,

Petitioner,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

JOSEPH M. PROSKAUER,
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November, 1939.

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Petitioner respectfully prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Second Circuit entered on June 12, 1939 (R. 46) modifying an order of the Board of Tax Appeals involving petitioner's 1932 income tax.

Opinions Below.

The opinion of the Board of Tax Appeals (R. 20-23) is reported in 37 B. T. A. 223. The opinion of the Circuit Court of Appeals (R. 46-47) is reported in 104 F. (2d) 649.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on June 12, 1939 (R. 46). Petition for re-

hearing was denied on June 28, 1939 (R. 52). An order granting an extension of 60 days to file the petition for certiorari was signed on September 26, 1939 (R. 54).

The jurisdiction of this Court is invoked under §240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

(1) In 1932 petitioner, engaged in the business of trading in securities, paid commissions on the purchase of securities to his Stock Exchange partnership, a portion of which commissions were returned to him in 1932 as part of his distributive and taxable share of the partnership income. Does *Helvering* v. *Winmill,* 305 U. S. 79, require the disallowance as a deduction from taxable income of such repaid portion of the commissions?

(2) Whether, under §23(r) of the Revenue Act of 1932, petitioner, engaged in the business of trading in securities, may offset losses on the sale of non-capital securities owned by him as an individual, against profits from the sale of non-capital securities owned by him and another as partners.

(3) Whether, if construed to deny such offset, §23(r) of the Revenue Act of 1932 is constitutional, as applied in this case, where petitioner's business activities in trading for his own account and for the account of the partnership against whose profits he seeks to offset his losses, were interwoven in one continuous course of business.

Statement.

The facts were stipulated (R. 12-14). From them the Board found (R. 20-22):

> The petitioner, an individual, resident of New York, New York, was a member of the New York Stock Exchange. He was engaged in the business of trading in securities on the floor of the Exchange for the partnership of Hilson & Neuberger, of which he was a member, executing orders on behalf of customers of the partnership and for his individual account.
>
> During the taxable year the petitioner sustained a net loss, from his individual trading, from sales or exchanges of stocks and bonds which were not capital assets (as defined in section 101 of the Revenue Act of 1932), in the aggregate sum of $25,588.93. In computing such loss he deducted stock transfer taxes and commissions on sales of securities from the selling price and he added commissions paid upon the purchases of securities to the cost and treated them as a part of the cost of securities sold. Federal and New York stock transfer taxes on such sales amounted to $2,779.69. Commissions paid during the year upon purchases and sales, respectively, were $2,133.63 and $2,306.98. These taxes and commissions—the latter having been paid to the aforesaid firm of Hilson & Neuberger and reported by it for income tax purposes in its return for that year—were not separately deducted in the petitioner's return for 1932.
>
> The petitioner's firm derived a profit of $142,802.29 in the taxable year from the sale of

> stocks and other securities which were not capital assets of the type hereinbefore indicated. It had other income (including commissions received) of $170,830.65 and deductions of $203,981.78, or a net income of $109,651.06[.16]. The petitioner's distributive share of said profits amounted to $36,000 of the first $94,000 and 45 percent of the remainder.

Paragraph 7 of the stipulation of facts (R. 14) reads in part:

> During the year 1932, petitioner was a member of the New York Stock Exchange, and spent practically every working day of the year 1932 on the floor of the Exchange, trading for the account of his firm (Hilson & Neuberger), executing orders on behalf of customers of said firm, and trading for his individual account.

The Commissioner determined a deficiency in income tax for the year 1932 arising mainly from the disallowance of petitioner's individual losses on his non-capital securities as an offset against the partnership's similar gains. The Board upheld the Commissioner on this issue, but held that, as petitioner was engaged in the business of trading in securities, he was entitled to deduct purchase and sales commissions paid in connection with his security trading business (R. 22-23).

Before the case was heard in the Court below, Congress stated its disapproval of the rule followed by the Board on the security loss issue, and in the Revenue Act of 1938 provided that individual and partnership security profits and losses could be offset

against each other. Section 182 of the Revenue Act of 1938, *infra*, page 12.

This change was fully presented to the Court below, but in a *per curiam* opinion that Court affirmed the Board on this point, and with respect to the commissions, it modified the Board's decision, following *Helvering* v. *Winmill*, 305 U. S. 79, by eliminating in full the deduction for purchase commissions (R. 47). The Court gave no weight to the distinguishing feature that here part of the purchase commissions were repaid to petitioner in the same taxable year and that such repaid part was included in his taxable income. A petition for rehearing (R. 48-51) was denied without opinion (R. 52).

Statutes and Regulations Involved.

Sections 23(r)(1) and 23(t) of the Revenue Act of 1932 provided as follows:

> (r) Limitation on Stock Losses.—
>
> (1) Losses from sales or exchanges of stocks and bonds (as defined in subsection (t) of this section) which are not capital assets (as defined in section 101) shall be allowed only to the extent of the gains from such sales or exchanges * * *.
>
> (t) Definition of Stocks and Bonds.—
>
> As used in subsections (r) and (s), the term "stocks and bonds" means (1) shares of stock in any corporation, or (2) rights to subscribe for or to receive such shares, or (3) bonds, debentures, notes, or certificates or other evidences of indebtedness, issued by any corporation (other than a government or political subdivision there-

of), with interest coupons or in registered form, or (4) certificates of profit, or of interest in property or accumulations, in any investment trust or similar organization holding or dealing in any of the instruments mentioned or described in this subsection, regardless of whether or not such investment trust or similar organization constitutes a corporation within the meaning of this Act.

Assignments of Error.

(1) The Court below erred in holding that petitioner, engaged in the business of trading in securities, could not deduct purchase commissions paid by him to his partnership to the extent that the commissions were returned to him in the same taxable year as part of his distributive and taxable share of the partnership's income.

(2) The Court below erred in holding that petitioner, who was in the business of trading in securities, could not offset losses from the sale of non-capital securities owned by him individually against profits from the sale of similar securities owned by him and another as partners.

(3) The Court below erred in holding that §23(r) of the Revenue Act of 1932, construed to prevent such an offset, was constitutional as applied to a case where the taxpayer's business activities in trading for his own account and for the account of the partnership against whose profits he seeks to offset his losses were interwoven into one continuous course of business. Construed as it was by the Court below in this case, §23(r) is so unreasonable and arbitrary as to violate the due process clause of the Fifth Amendment.

Reasons for Granting the Writ.

I.

The case presents important questions of Federal tax law which have not been, but should be, decided by this Court.

Sooner or later this Court will find it necessary to pass on the question whether partnership income retains its identity in the hands of the individual partners for income tax purposes, or loses such identity and becomes general income. This case presents two different aspects of this question. Other cases are now pending in the courts and the Bureau of Internal Revenue involving the same problem. Different phases of the problem have been frequently presented to the Bureau, the Board of Tax Appeals, and the courts, and will continue to be until this Court finally resolves the point. The views thus far expressed have been by no means unanimous **and Congress itself has indicated its disagreement with the view taken by the Bureau and the Court below in this case.**

The phases of the question presented in this case are:

(1) Whether commissions paid by a partner to his partnership retain their identity as commissions when distributed to the same partner. This question is pending in at least one Court of Claims case.

(2) Whether partnership security profits retain their identity as security profits in the hands of the partners. This question was presented in dozens of cases, some still pending. Congress has stated its disagreement with the view of the court below.

Other phases of the same question are:

(3) Whether interest paid by a partner to his partnership retains its identity as interest when distributed to the same partner. This question is pending in at least one Court of Claims case.

(4) Whether partnership dividend income retains its identity in the hands of the partner. This was the issue in *United States* v. *Coulby,* 258 Fed. 27 (C. C. A. 6th) discussed at length below, and believed to be in conflict with the decision of the Court below.

(5) Whether partnership wagering income retains its identity in the hands of the partner. This was the issue in *Zelda B. Jennings et al.,* B. T. A. Memo., July 25, 1939, Docket No. 94529; also in G. C. M. 21478, 1939 I. R. B. 35-9980.

(6) Whether tax-free covenant bond interest retains its identity in the hands of the partner. This was the question in G. C. M. 18120, 1937-1 C. B. 151.

(7) Whether partners are vested before distribution with an interest in specific firm property as coowners. This question comes up in connection with basis of partnership assets (*Helvering* v. *Walbridge,* 70 F. (2d) 683 (C. C. A. 2d), where the court below overruled G. C. M. 10092, XI-1 C. B. 114, in part); holding period of partnership assets distributed to partners (G. C. M. 20251, 1938-2 C. B. 169); whether an interest in a partnership is a capital asset or merely an interest in partnership income and assets (*Doyle* v. *Commissioner,* 102 F. (2d) 86 (C. C. A. 4th), *Rossmoore* v. *Commissioner,* 76 F. (2d) 520 (C. C. A. 2d), and *Helvering* v. *Smith,* 90 F. (2d) 590 (C. C. A. 2d) all of which appear to be in conflict with the decision below; *contra, D. T. Humphrey,* 32 B. T. A. 280).

II.

The decision below erroneously interprets this Court's decision in *Helvering* v. *Winmill*, 305 U. S. 79.

In the *Winmill* case this Court held that commissions paid upon the purchase of securities are not deductible from income but must be added to the cost of the securities. The Court below purported to follow the *Winmill* case, although here the commissions were paid by petitioner to his partnership and 45% of them were rebated to him and included in his income as part of his distributive share of the firm income. The Court below said that this fact "does not change their character as capital expenditures by the taxpayer. *To conform to the ruling of the Supreme Court,* the deduction of commissions on purchases must be disallowed." (Italics ours.)

There is not a word in the *Winmill* case to justify this extreme result. In that case, the commissions were disallowed as deductions and treated as part of the cost of the securities, although such action merely increased the loss on the sale of securities which the Court below had held to be non-deductible, with the result that the taxpayer was entirely deprived of the commissions as a deduction. Here the Court goes one step further and sanctions the taxation of petitioner upon the transfer of a non-deductible capital expenditure from himself to his partnership and back again without any accretion in his total wealth. The Court below erred in holding that this Court's decision required disallowance of the part of the purchase commissions which was rebated to him and included in his taxable income for the same year.

If this result is sought to be sustained on the theory that the commissions lost their identity as such, then the decision below conflicts with *United States* v. *Coulby,* 258 Fed. 27 (C. C. A. 6th), discussed in the next point.

III.

The decision below conflicts with that of the Sixth Circuit in *United States* v. *Coulby,* 258 Fed. 27.

On the issue whether petitioner's security losses could be offset against his share of the partnership's security profits, the Court below followed its earlier decision in *Johnston* v. *Commissioner,* 86 F. (2d) 732, Swan, *C. J.* dissenting. The basis of the holding was stated thus at page 734 of the *Johnston* case:

> "* * * when the partnership return shows net income a partner's distributive share is to be entered in his own return as his own income derived from the partnership without retaining the peculiar character it had in the partnership return unless Congress has expressly so provided and then only for the purpose stated."

In *United States* v. *Coulby,* 258 Fed. 27 (C. C. A. 6th), the question was whether dividends received by a partnership should be treated as dividends in the hands of the individual partners, and therefore exempt from normal tax, or whether, as contended by the Government, dividends received by the partnership should be fully taxable in the partner's hands because

they had lost their identity as such. There was no provision in the law covering the point.

The Court held for the taxpayer, holding that the dividends received by the partnership retained their identity as dividends in the hands of the partners. The basis of the holding was stated thus (251 Fed. 982 at 984):

> "The law is so framed as to deal with the gains and profits of a partnership as if they were the gains and profits of the individual partner. * * * The law looks through the fiction of a partnership and treats its profits and its earnings as those of the individual taxpayer. Unlike a corporation, a partnership has no legal existence aside from the members who compose it. The Congress, consequently, it would seem, ignored, for taxing purposes, a partnership's existence, *and placed the individual partner's share in its gains and profits on the same footing as if his income had been received directly by him without the intervention of a partnership name.*" (Italics ours.)

We challenge the Government to reconcile the conflicting points of view expressed by the Second Circuit in the *Johnston* case and by the Sixth Circuit in the *Coulby* case. None of the courts which have considered the instant question have discussed the *Coulby* case, although we asked the Court below to do so both in main argument and petition for rehearing (R. 49).

The conflict between the decision below and the *Coulby* case is all the more marked because both in

that case and in this Congress approved the taxpayer's view in a later Act. The Sixth Circuit said the later Act confirmed its interpretation of the partnership tax provisions (258 Fed. at 28; 251 Fed. at 985); the Court below did not see fit to discuss the 1938 Act (see petition for rehearing at R. 48).

IV.

The decision below conflicts with the decision of this Court in *Jordan* v. *Roche*, 228 U. S. 436.

The first general Revenue Act following the decision of the Court below in the *Johnston* case was the 1938 Act, in §182 of which[1] Congress expressly provided that security transactions of the partnership are to be carried over to the individual partner's returns as such. The Ways and Means Committee said that §182 was "a logical corollary of the principle that only the partners as individuals, not the partnership as an entity, are taxable persons * * *."[2]

---

[1] "Sec. 182—Tax of Partners.

In computing the net income of each partner, he shall include, whether or not distribution is made to him——

(a) As a part of his short-term capital gains or losses, his distributive share of the net short-term capital gain or loss of the partnership.

(b) As a part of his long-term capital gains or losses, his distributive share of the net long-term capital gain or loss of the partnership.

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in Section 183(b)."

[2] 75th Cong., 3rd. Sess., H. Rept. 1860, pp. 42-43. The Senate took the same view. 75th Cong., 3rd. Sess., S. Rept. 1567, p. 22.

As this corollary was no more logical in 1938 than in 1932 (the Act here in question), it is obvious that only the *Johnston* case made it necessary to put the corollary into the statute. (See the dissenting opinion of Swan, *C. J.*, 86 F. (2d) at 735, pointing out that prior to the 1932 Act, partnership security transactions retained their identity as such on the partner's returns and that the 1932 Act made no change in the partnership sections.)

Thus the situation is the same as faced this Court in *Jordan* v. *Roche,* 228 U. S. 436. There the question was the taxation, under the general provisions of an Act of 1900, of Porto Rico bay rum. In 1908, the Court below held the product exempt from tax. *Anderson* v. *Newhall,* 161 Fed. 906.

In 1909, Congress passed a statute specifically providing that Porto Rico bay rum was taxable. Then the *Jordan* case involving the 1900 statute came before this Court. It was contended that the 1909 statute was a declaration by Congress that the product was not taxable under the 1900 Act. This Court dismissed the contention as follows (228 U. S. at 445-6):

> "On February 4, 1909, Congress passed the act by which it is provided 'that upon bay rum, * * * hereafter brought from Porto Rico into the United States for consumption or sale, there shall be paid a tax of one dollar and ten cents per proof gallon,' * * *. It is insisted that this act is a declaration by Congress that bay rum was not subject to a tax under prior statutes. The history of the act rejects the contention and manifests that the act was passed in consequence of the decision in *Anderson* v. *Newhall,* and the

other decisions to which we have referred. The law was not the declaration of a new policy, but a more explicit expression of the purpose of the prior law, made necessary by the judicial construction of that law."

It will be noted that this is the same view expressed by the Sixth Circuit in the *Coulby* case discussing the provisions of a later Revenue Act with respect to the precise question now presented as to the nature of partnership income in the hands of the partners.

If the Government contends that the 1938 Act, as it affects the instant problem, represents a change in the partnership tax law, thus differing from the later Acts discussed in *Jordan* v. *Roche* and *United States* v. *Coulby*, then we challenge the Government to state when and where Congress enunciated a change in the principle, applied in the *Coulby* case, that partnership income retains its identity in the partner's hands.

V.

The case presents an important question of constitutional law which has not been, but should be, decided by this Court.

The constitutional question is whether, in the case of a man whose business has two phases, one profitable and one losing, Congress may tax him on the profits without allowing deduction for the losses. There is no decision of this or any other court on the point.

The petitioner was in the business of trading in securities on the floor of the Stock Exchange (R. 14,

20-21, 23). He traded for himself and for his partnership. His trading for the partnership was profitable; his own trading showed a loss. The Commissioner taxed him on the profits and disallowed the losses as a deduction. In answer to the argument that this is so unreasonable and arbitrary as to violate the due process clause of the Fifth Amendment, the Court below (R. 47) cited its own decision in *Davis* v. *United States,* 87 F. (2d) 323.

The *Davis* case is as different as day from night. Davis was a casual investor seeking to deduct security losses from his ordinary salary and other income. He was not in the business of trading in securities. The basis of the decision, repeatedly stated in the opinion, was that Congress could constitutionally deny deduction of casual security losses which were unrelated to the taxpayer's ordinary income. But Neuberger's losses arose out of the very business which was his main source of income—trading in securities on the floor of the Stock Exchange.

Constitutional questions are questions of degree. It shocks one's sense of fairness for Congress to divide up petitioner's business activity arbitrarily, taxing him on the profitable phase without deduction for the losing phase. No case goes so far in splitting a single course of business conduct for tax purposes.

Conclusion.

This is an extraordinary case. Petitioner was in the security trading business. The net result was a profit which he reported and on which he paid a tax. The Commissioner threw out the unprofitable business

transactions and increased the tax. The Court below upheld the Commissioner although there was nothing in the 1932 Act requiring it to do so and although, before it decided the case, Congress had stated its disagreement with the Commissioner's view. And then the Court went further—it taxed petitioner on a part of the unprofitable transactions, the security purchase commissions he had paid to the partnership and which were reflected in his distributive share of the firm income.

The case involves important questions of Federal tax and constitutional law which have not been but should be decided by this Court. The decision below is wrong, and conflicts with decisions of this Court and of the Sixth Circuit. The petition for certiorari should be granted.

Respectfully submitted,

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November, 1939.